THIRD QUARTER 2019 – TRUST & INVESTMENT MANAGEMENT'S

WEALTH MANAGEMENT UPDATE

Exchange Bank

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TRUST & INVESTMENT MANAGEMENT GROUP

Articles by:

Matthew C. Kelman
Vice President

Emily Menjou
Vice President

David S. Rapoport
Vice President

invest.exchangebank.com
707.524.3151

Investment Review and Outlook

By Matthew C. Kelman, *Vice President*

In a somewhat compressed version of the prior six months, the second quarter of 2019 saw a dramatic increase in financial market volatility followed by a significant stock market rebound that pushed U.S. stocks to new record highs. "Cross-currents," as the Federal Reserve has labeled them, continued to send conflicting signals through the global economy and financial markets, as mixed messages regarding geo-politics, trade negotiations and central bank monetary policy continued to ramp up.

The big story for financial markets throughout 2018 and the beginning of 2019 was around what the Federal Reserve would do with short-term interest rates while the impacts of 2017's tax-reform bill and increasing trade tensions played out against the backdrop of a steadily expanding U.S. economy. For most of 2018, financial markets and the Fed stayed on the same page regarding the need to raise rates, however a divergence in views began in the beginning of the fourth quarter as markets began to price in an expected slowdown for the U.S. economy (predominantly due to global factors including international trade) while the Fed continued to see the possible buildup in inflation pressures caused by a tightening labor market. In a fairly rapid succession of policy pivots, Federal Reserve policymakers went from expecting multiple additional rate hikes to be required this year, to a data-dependent stance of possibly no additional hikes, to a bias toward potential rate cuts within a relatively short five-month period. From a historical perspective, this series of policy changes was almost unheard of previously, outside of an instance in the mid-1990s when then Federal Reserve Chairman Alan Greenspan

MARKET PERCENTAGE TOTAL RETURNS AS OF JUNE 30, 2019

Index	Q2 2019	One Year	Five Years (annualized)	Ten Years (annualized)
Barclays U.S. Aggregate Bond Index	3.08	7.87	2.95	3.90
S&P 500 Index	4.30	10.42	10.71	14.70
Russell 2000 Index	2.10	-3.31	7.06	13.45
MSCI EAFE Index	3.68	1.08	2.25	6.90
MSCI Emerging Markets Index	0.61	1.21	2.49	5.81

pushed for a small series of rate cuts intended to extend the economic expansion at the time, while the economy was still solidly moving forward. As such, economists and financial market participants have had only limited experience with Fed rate cuts outside of recession.

Overall, global equity markets had a positive quarter with low single-digit returns, albeit one that reintroduced volatility that wasn't seen much in the first quarter. Domestic equities again generally outperformed their international counterparts, with developed market performance exceeding emerging markets that have been more heavily impacted by recent trade disruptions. Within the U.S. equity markets, large capitalization firms outperformed small-caps, while growth stocks continued their now decade-long dominance over value stocks.

In fixed income markets, the downward trajectory of long-term interest rates continued for a third straight quarter as the Federal Reserve implied a shift in their policy toward potential rate cuts (from the patient, data-dependent stance adopted in the first quarter). This change in direction caused a so called "bull steepening" in the yield curve with shorter duration securities falling in yield more than those focused on the longer term. This steepening caused the spread between 10-year and two-year treasuries to expand from 0.14% to 0.26%, although at much lower levels than have been seen in the past year.

In sum, global investors of all asset classes saw good returns through the second quarter. Going forward, we would expect to see a continuation of increased volatility in both interest rates and stock markets as the results of trade negotiations and potential policy shifts by global central banks get increasingly difficult to discount. As always, Exchange Bank recommends finding the right mix of assets to meet each of our clients' long-term risk and return needs, as attempting to time markets is difficult even in calmer markets than we are seeing today.

Municipal Bonds: The Goose that Lays Tax-Free Golden Eggs

By David S. Rapoport, *Vice President*

Municipal bonds, whether state or local government debt, are loans to entities that enable long-term financing of capital projects. Examples are roads, bridges, airports, schools, power plants, water treatment plants and public buildings. Collectively, these are often referred to as 'infrastructure." This type of public financing actually pre-dates the federal tax code by nearly a century. However, the code, since its inception in 1913, has always exempted municipal bond interest payments from taxable income. States have followed suit for municipal bonds issued within their borders, making single state municipal bond interest double tax-free to residents of that state.

The motive behind making municipal bond interest tax-free was (and remains) to encourage high-bracket tax payers to help finance local and statewide infrastructure. And, while this federal subsidy alone to such financing was estimated to cost $28 billion in 2018, no caps on earning tax-free interest are currently in effect. Compare that fact to the recently enacted cap on state and local tax (SALT) deductions from your individual federal tax return. It obviously helps explain why, in the first five months of 2019, more than $37 billion flowed into the municipal bond market nationwide. This was the fastest pace of inflow to start a year since flow data collection began in 1992.

Nationally, the total value of the municipal bond market is roughly $3.8 trillion. That number represents about one million individual securities from approximately 50,000 issuers. For comparison, the national corporate bond market, at around $9.2 trillion in value, represents about 30,000 individual securities from approximately 10,000 issuers.

Approximately two-thirds of the municipal bond market is owned by individuals, either via direct purchase or through pooled vehicles (mutual funds, exchange traded funds). Pooled vehicles typically offer much greater diversification, low access and operating costs and regular monthly income payments. The recent reduction in corporate tax rates, along with the $10,000 cap on state and local tax deductions for individual tax payers, suggests that municipal bond ownership will become even more of a retail buyer's market going forward.

Credit quality is always a high priority for bond investors, whether interest paid is taxable or tax free. In that regard, it is interesting to note that, historically, the default rate for investment grade municipal bonds has been one-tenth that of investment grade corporate bonds (0.18% vs. 1.74%, per data from Standard & Poor's and Moody's).

At Exchange Bank we utilize both individual municipal bonds and municipal bond funds to help clients achieve their income objectives and minimize taxes. Over many decades, municipal bond returns have had a negative correlation (i.e., move opposite) to stock market returns. Thus, you have been able to achieve effective portfolio diversification and receive tax-free income at the same time. To find out if municipal bonds could be right for your portfolio, speak with one of our investment officers to walk through the positives and negatives for your particular situation.

North Bay Business Journal's Wealth Advisor Profile 2019

By Emily Menjou, *Vice President*

Exchange Bank Trust and Investment Management is being featured in the North Bay Business Journal's special report on Wealth Management. The report will be included in the NBBJ's August 26th issue, and will include a Q&A with various wealth management advisors in our area. Not a current subscriber? You can check out the questions and our responses below.

NBBJ Question: ***What difference does age of a client make in what you suggest to them as an investment strategy?***

One general principle of investing is for clients to gradually reduce their risk exposure as they age, because older clients don't have as much time to rebound from market risk. That said, age should never be the sole determining factor for a client's investment strategy.

For example, an 85 year old client who requires 24 hour in-home care with large medical expenses would generally warrant a more conservative asset allocation than an 85 year old with minimal expenses who plans to leave wealth in trust for future generations. Every client is unique and asset allocations should be tailored to each client's individual financial goals.

NBBJ Question: ***How do you help a client determine what level of risk they are comfortable with when it comes to investing their money? Are there key questions you ask to assess that risk?***

Each client has an individual risk tolerance and a unique set of goals, which means that asset allocation is not a black and white decision. At Exchange Bank, we get to know our clients and work to understand their goals.

Asking questions about clients' families, careers and future plans helps build rapport and also paints a picture of what is important to each client. What does their current financial picture look like? What are their liquidity needs? What are the long term goals for their wealth? What keeps them up at night?

Once we have answers to some of these key questions, we are better positioned to advise on market exposure and the appropriate level of risk to achieve their goals.

NBBJ Question: ***With faster technology, algorithms to pick stocks and instantaneous investments, are clients making more frequent moves with their money, not being content to stay with investments for the long haul more these days? What do you tell them if you consider this approach unwise?***

We've found that when our clients understand and agree with our investment philosophy, they are not typically swayed by new trends in the investment world. Communication is key, both during the onboarding process and throughout the relationship. When our clients get antsy, we remind them of the plan and encourage them to stay the course.

NBBJ Question: ***What mistakes do you see individual investors making in the current financial climate?***

Despite all of the research out there to suggest that the markets are truly efficient, we still encounter clients who wish to time the market or make investment changes in response to our often turbulent political and economic climate. We counsel our clients against being reactive, in favor of a more passive investment approach centered on our core principles of diversification, asset allocation, and low costs. Having a plan and sticking with it is key for financial success.

NBBJ Question: ***What is your best advice on planning for a financially secure future?***

We may not all have inherited wealth or six figure salaries, but there are key actions that we can all take to build financial security. For starters, spend less than you earn, keep debt to a minimum, contribute to a retirement plan, and make saving a habit. If you are still working, be sure to maximize your employment benefits, especially if there is an employer match.

For clients with investable assets, keep your eye on costs within your portfolio. Make sure you understand how your advisor is compensated, and understand the expense ratios within the mutual funds you own as these will be a drag on returns.

Lastly, create an estate plan with a Will and a Trust to ensure your assets are managed in accordance with your wishes during a period of incapacity or after your passing.

Introduction: Tiffany Terrell, Assistant Vice President & Trust Officer

Dear Clients, Friends and Advisors: It is my pleasure to introduce Assistant Vice President and Trust Officer Tiffany Terrell. Tiffany will service the Sacramento metropolitan area alongside Alysia Corell and Kelly Lind of our Roseville office.

Tiffany previously served as assistant vice president and trust officer for WestAmerica Bank. She is a graduate of Cannon Financial Institute and has over 18 years of trust administration experience. In her position, Tiffany will administer complex trust accounts including revocable, irrevocable, charitable and terminating trusts.

Please join me in welcoming Tiffany to the Exchange Bank family.

Emily Menjou, *Vice President*

Email Delivery of Wealth Management Update

We are transitioning our Wealth Management Update newsletter to email delivery. The economic and market data we present is time sensitive and we can save considerable time in getting the information to you while it is fresh, accurate, and useful. We will continue to post a copy on Trust and Investment Management's website: **invest.exchangebank.com**. If you are a client or an estate planning professional and you have changed your email recently, please give us a call so that we can update our records. Print copies will continue to be mailed by request. If you would like to continue to receive this through the mail, please contact our office at the numbers listed on the front cover.

We hope you enjoy our quarterly update and musings, and we look forward to continuing our coverage of an array of wealth management topics that can assist you in meeting your investment, retirement, and estate planning goals.

If you would like to be removed from our mailing list, please contact: **ebmarketing@exchangebank.com**.